AMOCO PRODUCTION CO.

IBLA 95-213 Decided July 14, 1998

Appeal from that part of a decision of the Associate Director, Policy and Management Improvement, Minerals Management Service, requiring additional royalties on natural gas processed at the Wattenberg Processing Plant from Federal Lease No. 69-020905. MMS-86-0434-O&G.

Affirmed.

1. Oil and Gas Leases: Royalties: Natural Gas Liquid Products

When, under an agreement to sell wet gas, the seller exercises its option to receive and sell post-sales meter liquids during the period 1980-83, MMS may properly compute royalty, under 30 C.F.R. § 206.105(c) (1983), on the basis of the greater of the gross proceeds from the sale under the agreement or the aggregated value of all commodities, including the residue gas.

APPEARANCES: Charles A. Breer, Esq., Robert G. Leo, Jr., Esq., Charles L. Kaiser, Esq., Denver, Colorado, for Appellant; Peter J. Schaumberg, Esq., Howard W. Chalker, Esq., Geoffrey Heath, Esq., Sarah L. Inderbitzin, Esq., Lisa K. Hemmer, Esq., for the Minerals Management Service.

OPINION BY DEPUTY CHIEF ADMINISTRATIVE JUDGE HARRIS

On October 31, 1994, the Associate Director, Policy and Management Improvement, Minerals Management Service (MMS), issued a decision denying, in part, an appeal filed by Amoco Production Company (Amoco) of a determination by the MMS Royalty Compliance Division (RCD), Denver, Colorado, based on an audit conducted by the Colorado State Auditor's Office, that Amoco had underpaid royalties for natural gas and natural gas liquids produced from Federal Lease No. 69-020905 during the period January 1980 through December 1983.

Amoco is the lessee and royalty payor for Federal Lease No. 69-020905. A portion of the gas produced from the lease is processed through the Wattenberg Processing Plant, which is owned by Amoco. Gas processed through that plant is sold at the wellhead to Panhandle Eastern Pipeline

Company (PEPL) pursuant to a Gas Purchase and Sales Agreement (Agreement), dated November 4, 1970, as amended. 1/ Royalties on drip liquids and natural gas liquids reserved under that Agreement and sold separately are at issue here.

The Colorado State Audit resulted in a preliminary royalty underpayment determination, which the State communicated to Amoco by letter dated January 13, 1986. Therein, the State explained, with regard to the Wattenberg Plant, that Amoco paid Federal royalties based only on the wellhead price received from PEPL, but that a review of the Agreement disclosed that "Amoco also reserves the right to all drip liquids and liquid hydrocarbons. Thus, the total consideration received for the Federally interested product is Amoco's gross proceeds received for all products." (Statement of Reasons (SOR), Ex. 2, at 2.) 2/

By letter of July 24, 1986, the RCD directed Amoco to pay additional royalties as determined by the Colorado State Auditor. Amoco appealed. In her October 31, 1994, decision, the Associate Director held that under 30 C.F.R. § 206.103 (1983) the proceeds Amoco received from the sale of drip liquids and liquid hydrocarbons were part of the total consideration flowing to Amoco under its sales contract with PEPL and that those proceeds should have been included in its royalty calculations from the lease. She found that Amoco effectively retained 100 percent of the natural gas liquids and drip gasoline; that Amoco sold these products after they were processed at the Wattenberg Plant; and that Amoco retained 100 percent of the profits from those sales.

The Associate Director then looked to the "substance and not the form" of Amoco's transactions and found that instead of exercising its right to "retain" natural gas liquids from its lease production, Amoco repurchased the natural gas liquids from PEPL, in effect using "two separate contracts to accomplish what it could have accomplished in one." (Decision at 8-9.) She concluded with respect to valuation that Amoco's proceeds from its contract sales price "were properly compared with the value derived from the net realization method." 3/ (Decision at 9.) However, the Associate Director held that the State had failed to make an adjustment for the costs associated with "processing of the subject natural gas liquids." Id. She remanded the case for consideration of the proper allowance. Amoco

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1/ A copy of the Agreement and its Amendment is appended as Ex. 1 to Amoco's Reply to MMS' Answer.

2/ Although the audit covered other transactions, all that is at issue in this appeal are the Wattenberg Plant post-sales meter transactions. See MMS' Answer, notes 1 and 2; SOR at 2-3. In its Answer at 3, note 2, MMS states that the amount in issue is $14,835.36. The figure represents the total of the alleged nonpayment of royalties on sales of Wattenberg plant products ($14,248.51) and sales of Wattenberg drip line liquids ($586.85).

3/ The "net realization method" is authorized by 30 C.F.R. §§ 206.103, 206.105, and 206.106 (1983).

appealed arguing that it had properly paid royalty on its contract price and that the net realization method was improper in this case.

Amoco asserts that, under the Agreement, gas is sold to PEPL "at the wellhead." (SOR at 4.) Amoco contends that "for purposes of determining the royalty * * * one looks only to the sale of the full production stream at the wellhead" and not to the "sale of the products produced by the gas processing plant." (SOR at 4.)

As explained by Amoco, title, possession, and control of the full stream of gas were transferred to PEPL at the wellhead and Amoco paid royalty based upon the proceeds it received for sale of the full production stream at the wellhead. Further, Amoco states that, after sale at the wellhead, the gas was commingled with other gas from the Wattenberg field and transported to the Wattenberg Plant for processing. (SOR at 4.)

Amoco asserts that one of the conditions of the exercise of its election to process under Article XXIV of the Agreement was the requirement to reimburse PEPL for the reduction in heating value and volume of the gas due to processing and removal of the liquids at the same price PEPL had paid at the well. Amoco contends that, if it elects to process the gas, "it must, in essence, repurchase the liquids from PEPL." 4/ (SOR at 4-5.)

Amoco argues that the Agreement reservation "does not mean the entire stream of gas is not sold at the well" but "creates an independent contract right or option to process and purchase liquids under very limited conditions." (SOR at 5.)

In its Answer, MMS focuses on the language of Article III, Section 3.1, of the Agreement, which provided that Amoco reserved:

> (e) All liquid hydrocarbons, oil or condensate removed by Sellers by means of drips or conventional gas-liquid separator from the gas produced from the Contract Acreage prior to delivery to the Buyer.
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> (f) All liquid hydrocarbons, helium, elemental sulfur and other non-hydrocarbon components of the gas Sellers remove or cause to be removed from the gas produced from the Contract Acreage by processing under the provisions of Article XXIV of this Agreement.

MMS contends that this language shows that Amoco reserved all the natural gas liquids and drip liquids and "never gave up the right to those products." (Answer at 2.) MMS' position is that the proceeds Amoco

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4/ Although the Associate Director stated in her Decision that Amoco purchased the liquids from PEPL, in its Answer MMS disputes that characterization stating that Amoco had reserved the liquids and reimbursed PEPL. (Answer at 5, note 3.)

received from reserved natural gas liquids and drip liquids should have been included as part of Amoco's gross proceeds because they are part of the total consideration it received for its production. (Answer at 7.) MMS asserts that Article XXIV of the Agreement "is not an option to `repurchase' the liquids [but] an unambiguous reservation of the liquids." (Answer at 8.) Because Amoco reserved those liquids, MMS argues, it did not sell them to PEPL, and, thus, could not have repurchased them. Amoco's reimbursements to PEPL for gas volume and heating value adjustments were not a "purchase" of the liquids, according to MMS. (Answer at 10.)

MMS asserts that Amoco's valuation is contrary to 30 C.F.R. § 206.105(c) (1983) which provides: "For the purpose of computing royalty, the value of wet gas shall be either the gross proceeds accruing to the lessee from the sale thereof or the aggregate value determined by the Secretary of all commodities, including residue gas, obtained therefrom, whichever is greater." Citing Kerr-McGee Corp., 106 IBLA 72, 78 (1988), MMS argues that, if the sale of wet gas to PEPL is treated as the sale of the entire wet gas stream, Amoco was required to compare the price it received to the value of the dry residue gas after processing plus the value of the extracted liquids, less a processing allowance, and to pay the higher of the two. (Answer at 11.)

Finally, MMS asserts that, regardless of whether Amoco sold the entire gas stream to PEPL, it was required to compare the price it received from PEPL to the value of the dry residue gas after processing plus the value of the extracted liquids, less a processing allowance, and pay royalty on the greater of the two.

In a Reply to MMS' Answer, Amoco asserts that MMS' premise that Amoco sold only the residue gas to PEPL and reserved the liquids to itself is incorrect and based on an erroneous interpretation of Article III resulting from reading that article in isolation from other provisions of the Agreement. Amoco explains that Sections 3.1(e) and (f) of Article III address different liquids:

> The first kind of liquids is addressed in Section 3.1(e) of the Agreement. These are drip liquids which fall out before the PEPL sales meter and are therefore never sold to PEPL. Amoco is required to pay royalties on these drip liquids. However, the second type of liquids, which are addressed in Section 3.1(f), are fundamentally different and are not royalty bearing. Those liquids -- consisting of both drip liquids and natural gas liquids ("NGLs") -- are removed from the entrained gas after passing PEPL's sales meter. See Exhibit 1 at 6. Unlike Section 3.1(e) liquids, Amoco does not automatically receive these liquids. Rather, it must exercise an election under Article XXIV and comply with the terms of that provision before receiving the post-sales meter liquids. Id.

> The Section 3.1(f) drip liquids condense in PEPL's gathering system lines after the PEPL sales meter. Under the procedures set forth in the 1976 amendment to Section 24.3, Amoco was allowed to elect to remove those drip liquids on PEPL's behalf. See Exhibit 1 at 87-90. If Amoco elected to remove the drip liquids, PEPL then billed Amoco for the value of the removed liquids. Id.
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> The NGLs included in Section 3.1(f) must, like the gathering system drip liquids, be obtained "under the provisions of Article XXIV." See Exhibit 1 at 6. According to Section 24.1 Amoco had the option, but not the obligation, to process and extract the NGLs. Id. at 28-29. Among the restrictions on Amoco's election to process was the requirement that it pay PEPL for any reduction in heating value and volume of the gas due to processing and removal of the liquids. As explained in its initial Statement of Reasons, Amoco repurchased the liquids from PEPL by paying PEPL for the lost BTUs and volume. See Statement of Reasons at 4-5.
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> In instances where Amoco elected to process and extract the post-sales meter liquids, it paid PEPL and then sold the liquids to a third party. Amoco did not pay royalties on the sale of post-sales meter liquids because it had already paid royalties on them when it paid royalties on the amount it received from PEPL for the entire stream of gas (including all liquids) at the sales meter.

(Reply at 3-4 (footnote omitted).)

Thus, Amoco admits that it is required to pay royalty on the Section 3.1(e) drip liquids; however, regarding Section 3.1(f) liquids, Amoco charges that MMS has ignored the relationship between Section 3.1(f) and Article XXIV. Amoco asserts that, as stated in that Article and as reflected in the course of dealing between PEPL and Amoco, "Amoco had to pay back or reimburse PEPL for the lost volume and heating content attributed to the post-sales meter liquids." (Reply at 6.) Amoco points out that, rather than a reimbursement for the reduced volume and heating value of the dry residue gas, as claimed by MMS, the reimbursement was, in accordance with Section 24.3(b) of the Agreement, "for the equivalent heat content in BTU's per cubic foot attributable to the liquid hydrocarbons removed." (Reply at 6; see Ex. 1, at 87-88.)

Amoco also contends that MMS' assertion that additional royalties are due even if Amoco sold the entire gas stream at the wellhead is erroneous because MMS ignores the fact that its sale to PEPL was not only for dry gas residue.

Section 17 of the Mineral Leasing Act, as amended, 30 U.S.C. § 226 (1994), requires the payment of royalty based on the "amount or value of production removed or sold from the lease." The statute does not impose any particular method for valuing production removed or sold from a Federal oil and gas lease; rather it authorizes the Secretary of the Interior "to prescribe necessary and proper rules and regulations and to do any and all things necessary to carry out and accomplish the purposes" of the Act. 30 U.S.C. § 189 (1994). Thus, the Secretary has the authority and responsibility to establish the reasonable value of production for royalty purposes, as well as considerable discretion in determining that value. See, e.g., Ladd Petroleum Corp., 127 IBLA 163, 168 (1993); Amoco Production Co., 126 IBLA 124, 126 (1993), and cases cited therein; Wexpro Co., 106 IBLA 57, 61 (1988).

The threshold issue is whether the proceeds Amoco realized from its sales of Section 3.1(f) natural gas liquids and drip liquids are subject to Federal royalty. An analysis of the Agreement leads us to the conclusion that those liquids are subject to royalty to the extent discussed below.

[1] Amoco emphasizes the importance of reading the "reservation" of Section 3.1(f) in conjunction with the remainder of the Agreement, particularly Article XXIV. We agree with Amoco that Article XXIV provides it with an option. Section 24.1 states:

> Sellers may elect to process, or cause to be processed for the extraction of components of the Gas delivered to the Buyer hereunder but such processing shall be governed by the following:
>
> > (a) In the event Sellers do so elect, Sellers shall notify Buyer of said election to process within two (2) years of the date of first delivery of gas hereunder, and if Sellers do not so notify Buyer or if Sellers so notify Buyer but fail to commence such processing before the end of the fourth (4th) year from such date, Sellers' right to process shall cease.

In this case, Amoco exercised the Section 24.1(a) option by electing to process the gas and, thereafter, processing the gas at its Wattenburg Plant. The exercise of that option, however, triggered the reservation of Section 3.1(f), reserving to the Seller "[a]ll liquid hydrocarbons, helium, elemental sulfur and other non-hydrocarbon components of the gas Sellers remove or cause to be removed from the gas produced from the Contract Acreage by processing under the provisions of Article XXIV of this Agreement." (Emphasis added.) Thus, under the language of Section 3.1(f), all liquid hydrocarbons in gas sold after the exercise of the Section 24.1(a) option were, as in this case, reserved to Amoco. 5/ For that reason, Amoco was responsible for royalty on those liquids.

5/ We note that the contract definition of "gas" in Section 2.1 of the Agreement is "the entire stream flowing from a well including all components, elements, mixtures indigenous to the reservoir and including Casinghead Gas, Associated Gas and Non-Associated Gas but excluding crude oil, condensate, liquid hydrocarbons, helium, elemental sulfur, other non-hydrocarbon components and water, if any, removed in accordance with the provisions of this Agreement." (Emphasis added.)

Amoco's arguments concerning Section 24.3 must be rejected as irrelevant because that section deals with the situation in which Amoco elected "to receive condensed liquid hydrocarbons removed and saved from the gas stream in Buyer's gathering system through the utilization of Buyer's existing or future liquid terminal facilities." (Emphasis added.) This provision is an alternative to Section 24.1, which was the provision invoked by Amoco, as the owner of the Wattenberg facility.

Alternatively, we note that the regulations provided at 30 C.F.R. § 206.105(c) (1983): "For the purpose of computing royalty, the value of wet gas shall be either the gross proceeds accruing to the lessee from the sale thereof or the aggregate value determined by the Secretary of all commodities, including residue gas, obtained therefrom, whichever is greater."

Amoco asserts, however, that in 1980-81, gas from the lease "would be valued according to NTL-5 [Notice to Lessees and Operators of Federal Onshore and Indian Leases No. 5, 42 Fed. Reg. 22610 (1977)], and not the regulations set forth in 30 C.F.R. Part 206." (Reply at 9.) Amoco claims that, according to NTL-5, the gas in question would be valued at the price received by the lessee. For the period 1982-83, however, it states that NTL-5 required gas to be valued according to 30 C.F.R. Part 206, but, it asserts, MMS did not correctly apply the regulations, because "MMS takes the value of the gas as sold at the well (which it believes is dry residue gas but as demonstrated above actually includes liquids), adds the value of the liquids determined by Amoco's sale to a third party, and then subtracts processing costs." (Reply at 9.)

In a Response to Amoco's Reply, MMS asserts that both NTL-5 and 30 C.F.R. § 206.105(c) apply and that they are not inconsistent. We must agree with MMS. NTL-5's provisions related to the valuation of dry residue gas. They did not govern the valuation of liquids. The regulation in question, 30 C.F.R. § 206.105(c) (1983) (previously codified at 30 C.F.R. § 221.50(c) (1976)), was in existence at the time of issuance of NTL-5 and NTL-5 did not repeal it. See generally Amoco Production Co., 126 IBLA 124 (1993); Kerr-McGee Corp., 125 IBLA 279 (1993).

Amoco sold the wet gas stream to PEPL, but by exercising its option under the Agreement, it reserved post-sales meter liquids, which it subsequently sold. In that situation, the Secretary was not limited to accepting, for purposes of royalty valuation, gross proceeds under the Agreement; he was authorized to determine the aggregated value of all commodities, including the residue gas, and compute royalty on the greater of the two.

Amoco complains that MMS did not apply 30 C.F.R. § 206.105(c) (1983) correctly. Amoco asserts that MMS arrived at the royalty in this case by taking the value of the gas at the well head, as though it were dry gas, and adding to it the value of the liquids, as determined by Amoco's sale to a third party, less a processing allowance. In essence, Amoco is complaining that it is paying a double royalty on the liquids. However, as explained by counsel for MMS, 30 C.F.R. § 206.105(c) would be applied in this case as follows:

> [T]he proceeds received for the wet gas -- the price PEPL paid -- would be compared to the value of the dry residue gas (the PEPL price minus the reimbursement for the heating value adjustment and volume reduction during processing) plus the value of the liquids (the price Amoco received from the sale of the liquids to third parties) minus the appropriate processing allowance. The royalty is the greater of the two.

(Answer at 11.)

Therefore, according to MMS, there is no double counting for liquids. The gas is valued as though it were dry residue gas because Amoco is given a credit against the PEPL price for the amount it reimburses PEPL for the heating value adjustment and volume reduction, but MMS adds to the gas value the value of the liquids, based on the price received by Amoco, and subtracts a processing allowance.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the decision appealed from is affirmed.

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Bruce R. Harris
Deputy Chief Administrative Judge

I concur:

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James L. Burski
Administrative Judge